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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 92-266

COMMENTS OF VIACOM INTERNATIONAL INC.

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SUMMARY

In this proceeding, the Commission seeks to refine its regulatory scheme for cable so that marketplace incentives for increased investment in cable program services are preserved. Viacom favors an approach that would allow operators to recover their programming costs plus a reasonable mark-up on increases in such costs. Of the three proposed methods for adjusting the benchmark for channel additions, Viacom prefers the first approach because it would best ensure operators' recovery of program costs, and partially offset non-programming capital costs incurred in adding channels. Viacom nonetheless accepts the Commission's favored approach as it serves the limited, but critical, purpose of allowing recovery of programming costs.

Permitting operators a reasonable profit margin on programming cost increases would preserve operators' incentives to support increases in value and quality of program services. Although the Commission has allowed operators to pass through programming cost increases, a natural economic incentive to increase such investment is severely curtailed because operators remain precluded from earning a profit on this sum. A mark-up mechanism would be fully consistent not only with the programming policies of the 1992 Cable Act, but also with the Commission's asserted goal of producing rates that replicate rate levels produced under competition.

In light of the Commission's tentative choice of a limited benchmark adjustment method for added channels, it is critical that operators be permitted to recover the costs of system upgrades by other means without resort to cost-of-service showings.

Accordingly, Viacom supports the FCC's proposal to allow operators that have recently completed or are in the process of upgrades to raise rates to the benchmark level without a cost showing. In any event, operators should be allowed to pass through costs incurred in complying with a franchise-required upgrade, consistent with the rule clarified in the Reconsideration Order. Rate adjustments based on such pass throughs should be governed solely by the FCC's cost-of-service rules.

Finally, Viacom urges the Commission to allow systems whose costs justify expanded tier rates beyond benchmark levels to present a cost-of-service showing at the FCC, without also undertaking a local cost showing to justify basic rates that are consistent with benchmark levels. Because operators filing cost showings at the FCC must produce cost data reflecting allocations across both the expanded and basic tiers, operators could easily derive the cost-based rate data for both basic and expanded tiers and compare it to the benchmark levels. This proposal eliminates the possibility for "gaming", while also minimizing the collective burden of cost-of-service showings.

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Viacom International Inc. ("Viacom"), by its attorneys, hereby submits these comments in response to the Commission's Third Notice of Proposed Rulemaking in its rate regulation proceeding. In this proceeding, the FCC is seeking to refine several critical elements of its regulatory framework for cable rate regulation that threaten to eliminate existing marketplace incentives for investment in improved cable service and programming.[1] In this regard, Viacom urges the Commission to tailor its regulations, as directed by the Cable Television Consumer Protection and Competition Act of 1992,[2] to allow cable operators to continue to increase their investments in more and better programming, as well as in system improvements used to carry that enhanced programming fare.

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[1] See Rate Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-177 (released May 3, 1993) ("Rate Order").

[2] Pub. L. No. 102-385, 106 Stat. 1460 (1992) (the "Act" or "1992 Cable Act").

As the Commission is well aware, the 1992 Cable Act fundamentally seeks to promote the diversity of information through the expansion of cable television, in general, and video program services, in particular. See 1992 Cable Act at §§ 2(b)(1), 2(b)(3). Indeed, in light of this clear statutory mandate, the Commission has repeatedly stated that "we attach greater importance at this initial stage of rate regulation to assuring the continued growth of programming" even than to assuring that rates do not rise rapidly. Rate Order at ¶ 215; Reconsideration Order at ¶ 114.[3] This view should certainly guide the Commission in this proceeding, as the proposals at issue here pose no risk of unwarranted rate increases.

Consistent with this perspective, the Third NPRM attempts to modify those aspects of the benchmark/price cap scheme which would likely discourage cable operators from increasing program investment. Viacom -- together with local regulators and a broad range of other commenters in this docket -- emphatically supports the FCC's effort to tailor cable rate regulation to ensure that operators fully retain the economic incentive to improve the quality and breadth of programming they provide the American viewing public.

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[3] First Order on Reconsideration, Second Report & Order, and Third Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-428 (released August 27, 1993) ("Third NPRM", "NPRM" or "Reconsideration Order").

In accordance with the 1992 Cable Act, the Third NPRM at least implicitly recognizes that a predicate to increased investment in programming is capital investment in system upgrades to expand the channel capacity and technical capabilities of cable systems. See 1992 Cable Act at §2(b)(3) ("It is the policy of Congress in this Act to .... ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems"). Consequently, the Commission has advanced certain proposals to increase operators' ability, in particular circumstances, to recover capital improvement costs under the benchmark system. The rules ultimately adopted by the Commission should indeed duly account for both the "software" and the "hardware" costs incurred by operators in offering viewers an ever greater supply of programming options.

Viacom believes that its suggestions detailed below, if adopted, would promote Congress' intent in the 1992 Cable Act to ensure that cable subscribers receive the greatest quantity and quality of programming possible. Accordingly, Viacom urges the FCC to modify its benchmark/price cap regulatory framework in the manner indicated below.

I. THE COMMISSION SHOULD ENSURE THAT CABLE OPERATORS RETAIN MARKETPLACE INCENTIVES TO INCREASE INVESTMENT IN BOTH EXISTING AND NEW PROGRAM SERVICES OFFERED ON REGULATED TIERS

Cable operators improve viewers' programming fare in two distinct ways: first, by adding previously uncarried program services to their systems and, second, by supporting the efforts of already-carried program services to improve the value and quality of their programming product. The resulting relationship between cable operators and programmers, as commenters from both sides of that relationship have explained, is one in which both parties share the risks and rewards of providing video programming to the public. Because operators must share some of the risk of a program service's success or failure, the continued growth of program services -- especially those targeted at "niche" audiences and minority groups -- depends on the willingness of operators to undertake that risk. If not eliminated, certain disincentives embodied in the Commission's current benchmark/price cap rules would distort this critical marketplace risk/reward calculus and leave operators significantly less inclined to add new and innovative programming.[4]

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[4] Cf. Rate Order at ¶ 8. (Congress did not intend to regulate program services or unnecessarily constrain the program services industry).

The Commission has thus appropriately identified two open issues critical to maintaining robust cable operator investment in programming under rate regulation: (1) the need for a method to adjust the benchmark rates when channels subject to regulation are added to a system; and (2) the need to allow operators a reasonable profit on increased programming investment, in general.[5] In seeking to promote programming, the FCC should bear in mind that these are two distinct issues in the regulation of program investment. Operators adding channels and new program services must be allowed to recover increased programming costs incurred as a result. Irrespective of the number of channels on a system, however, operators should be encouraged to maintain and increase investment in already-carried and regulated program services by allowing a reasonable profit on increases in the costs of those services.

A. The Benchmark Adjustment for Adding Channels Should, At A Minimum, Allow Cable Operators To Recover All Programming Costs

Viacom welcomes the Commission's effort to provide a benchmark adjustment that would allow cable operators to

[5] The Third NPRM raises a full series of questions concerning the proposed mark-up of programming costs, yet it states that this issue will be resolved in the cost-of-service proceeding. NPRM at ¶ 135 n.244. Accordingly, Viacom respectfully requests that this pleading be incorporated, as well, in that docket (MM Docket No. 93-215).

recover the increased programming costs incurred in adding channels to their regulated tiers of service. Viacom finds that the Commission's favored approach to benchmark adjustments would generally ensure the recovery of those programming costs, but not the capital and other costs inherent in the system upgrade typically preceding the addition of program services. Thus it would remain necessary for the FCC to provide some additional mechanism -- such as its streamlined cost-of-service proposal -- to ensure the recovery of these critical capital and other non-programming costs.

The Third NPRM puts forth for discussion three possible methods to adjust benchmark rates when adding channels: (1) price existing channels at current permitted rates, but price new channels at the lower marginal benchmark rate corresponding to the new total number of channels on the tier; (2) price both the existing and the new channels at the lower marginal benchmark rate corresponding to the new total number of channels on the tier; or (3) price all channels at a marginal rate calculated by reducing the current permitted per channel rate (less preexisting programming costs) by an amount proportionate to the decline in the corresponding benchmark rate resulting from the adding of channels, then add to this base the total programming costs per channel. Third NPRM at ¶¶ 135-144.

As an initial matter, Viacom concurs in the FCC's tentative conclusion that the second approach should be rejected. Indeed, the second approach is not so much a proposed solution as a restatement of the problem: as operators add channels to their systems, the benchmark rate declines and thus lowers operators' marginal revenue for all existing services. See id. at ¶¶ 134, 138. Rather than basing the decision to add a channel on the normal marketplace calculus, this approach would force operators to assess whether the new channel would produce incremental revenue sufficient to offset the decreased revenues from every other channel. Moreover, if (as the Third NPRM appears to suggest) operators with permitted rates above benchmarks would be required to drop to benchmark levels upon adding new channels to the tier, that tier simply would not contain any new program offerings. Thus, the incentive created by this approach is either to forgo adding programming altogether or to offer new (or existing, but relatively expensive) program services on an unregulated, a la carte basis only.[6]

In contrast, the Commission's third approach is specifically designed to serve the narrow purpose of allowing

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[6] This artificial incentive could disserve both programmers, who must attempt to replace the lost advertising revenue available from carriage on a widely distributed tier with higher programming fees, and subscribers, who in turn must absorb those higher programming fees.

operators to recover their added programming expenses.[7] This approach would take a significant step toward reducing the disincentive to add channels by allowing operators to recover their actual programming expenses. Thus, this may well suffice where operators, even after fulfilling "must-carry" requirements, possess excess channel capacity. This approach does not, however, even attempt to ensure recovery of the capital improvement costs that are the prerequisite to adding program services for systems with no available capacity. Indeed, as discussed further in Section II, infra, the small incremental revenue provided by this method of benchmark adjustment (apart from that dedicated to added programming costs) would rarely allow the full recovery of all upgrade costs absent a cost-of-service showing. While the Commission disfavors the first benchmark adjustment proposal, this method would provide operators upgrading their systems a simple mechanism possibly allowing the recovery of enough capital costs to warrant forgoing the collective burden of a cost-of-service showing. Viacom nonetheless supports the third approach to the extent it serves the limited, but important, purpose of allowing recovery of

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[7] This approach assumes, of course, that the preexisting benchmark did in fact cover all necessary costs, and provide a reasonable return, for the provision of regulated service. As Viacom has previously demonstrated, however, often this will not be the case. See Viacom Petition for Reconsideration and Clarification in MM Docket No. 92-266 (filed June 21, 1993) at 2-3 and Appendix.

programming costs when channels are added under the benchmark/price cap system.

B. Incorporating a Reasonable Profit Margin Into The External Cost Adjustment for Programming Cost Increases Would Preserve Cable Operators' Incentives To Support The Upgrading of Existing Program Services

While the Commission's price cap mechanism allows operators to pass through programming cost increases in excess of inflation, operators remain precluded from earning a profit on these increases. Operators are thus denied a profit incentive to increase their investment in programming. Over time, moveover, whatever profit margin might initially exist under benchmark regulation will erode as further programming cost increases (and other external costs) are passed through without any mark-up and as the GNP-PI adjustment inevitably falls short of covering the increases in all internal costs. Viacom therefore urges the Commission to resurrect the natural economic incentives that drive the video programming business by allowing operators to mark-up programming cost increases.[8]

Such an approach is consistent not only with the programming policy goals of the 1992 Cable Act, but also with

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[8] A simple and logical measure of the proper mark-up would be the rate-of-return the Commission ultimately adopts in its cost-of-service proceeding.

rate regulations that attempt to replicate competition.[9] Indeed, the Reconsideration Order makes clear that "competing businesses must charge rates that are designed to cover all relevant costs and to provide for a profit in order to remain in business." Reconsideration Order at ¶ 13 (emphasis added). As this passage suggests, in a competitive scenario all of a cable operator's investment -- whether characterized as a cost or an expense in utility law -- may be subject to a mark-up. Thus, a profit on additional programming expense, like a profit on any other investment, is entirely consistent with the Commission's goal of establishing rates no higher than those prevailing under competition. See NPRM at ¶ 135 n.244.

The Commission's suggestion that mark-ups might make "advertising-supported programming less attractive to operators than fee-supported programming," Third NPRM at ¶ 135 n. 244, overlooks the variety of factors that bear on an operator's decision to carry a given program services, the most important of which is viewer interest. Further, all else being equal, operators would be disinclined to carry a service with significantly increasing programming fees over

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[9] The Commission has repeatedly stated that its goal in crafting cable rate regulations is that "subscribers pay rates consistent with a level of rates that would prevail if their systems were subject to effective competition." Reconsideration Order at ¶ 12; accord Rate Order at ¶¶ 14, 15, 180 and 205.

one whose fees remain fairly stable. Cf. Rate Order at ¶ 251 ("We believe . . . that cable operators also have incentives to assure that service rates are not excessive since excessive programming costs, if passed on to subscribers, may cause them to lose subscribers").

The Third NPRM queries whether different categories of program services should be treated differently for purposes of establishing a mark-up. Viacom respectfully submits that there is no compelling reason to distinguish among various categories of program services in adopting a programming profit margin. Retransmission consent costs are no different from programming costs for satellite channels in this regard. Moreover, if the FCC treats retransmission consent costs differently from other programming costs, then it could face the difficult task of separating retransmission costs from programming costs in retransmission consent arrangements where compensation is substantially or exclusively on a non-cash basis (e.g., provision of a second channel).[10]

Similarly, no basis exists to treat affiliate transactions differently for purposes of programming cost

[10] The suggestion in the NPRM that the "profit associated with broadcast retransmissions is already present in benchmark rates" is not only unfounded, but also inapposite. See NPRM at ¶ 135 n.244. Even if such profits were reflected in current benchmark rates, the cost of retransmission consent, like the cost of any other programming, could rise periodically and thus warrant a mark-up on that increase.

mark-ups. The market-based safeguard for affiliate transactions adopted in the Reconsideration Order already ensures against any potential to inflate the profit built into such transactions. See Reconsideration Order at ¶ 114. Under that rule, cable operators may pass-through increases in the cost of programming from affiliated entities that exceed inflation only to the extent that the price charged to the affiliated system reflects prevailing marketplace prices or the fair market value of the programming. Id. Furthermore, given the vital role that vertically-integrated operators play in supporting the viability of many program services, restrictions on mark-ups of affiliated programming would seriously undermine the Commission's intent to "attach great importance at this stage of rate regulation to the continued growth of programming." Reconsideration Order at ¶ 114.

The NPRM also asks how to treat provisions of programming contracts that affect the level of programming expense. Third NPRM at ¶ 135 n. 144. The Rate Order requires that any sums received from a programmer, or shared by a programmer and operator, for the carriage of programming be netted against costs for determining whether there has been an increase or decrease in programming costs for the operator. Rate Order at ¶ 253 n.602. This approach should apply in this context, as well, to promotional money or certain other sums directly provided to the cable operator on the face of, and as consideration for, the affiliation agreement. However, offsetting not only the consideration for, but also the future revenue generated by, affiliation agreements would erode the incentive for operators to increase investment in programming.[11]

Finally, Viacom urges the Commission to exercise caution in requiring "mark-ups" of reductions in program expense. Operators should not be discouraged from any efforts to keep programming costs down. Certainly, no such mark-up should be applied to programming cost reductions that exceed the amount of increases previously marked-up under price cap regulation, for this would assume without foundation that the original benchmark rate fully provided such a mark-up from the start. As with other issues in this proceeding, the FCC should focus on creating the proper incentives, not the impression of symmetry.

II. THE COMMISSION SHOULD PROVIDE THE READY MEANS FOR CABLE OPERATORS TO RECOVER THE FULL COSTS OF SYSTEM UPGRADES, INCLUDING THOSE REQUIRED BY FRANCHISE OR JUST RECENTLY COMPLETED

The benchmark/price cap scheme is founded, in large part, on the empirical premise that expanded channel capacity

[11] In addition, revenues that arise after the point of transaction, such as advertising revenue, could be difficult to account for.

will result in the provision of more programming to the public at lower prices. See Rate Order, Appendix E, Survey Results: Technical Issues, ¶ 27. Indeed, the expansion of channel capacity is generally a prerequisite to the addition of channels. Yet increasing channel capacity requires revenue sufficient to cover the cost of the necessary capital improvements, and the Commission has yet to provide a ready means of recovering such costs under rate regulation.

Significantly, the Reconsideration Order affirmed the Commission's decision that operators may not pass-through costs associated with upgrade and other capital improvements, but rather must seek to recover fully these costs through cost-of-service showings. Reconsideration Order at ¶¶ 94, 97. Obviously, operators would be significantly discouraged from making critical investments in capital improvements if they were effectively required to undertake a full cost-of-service showing to ensure the recovery of such costs and a fair return. The Commission has thus proposed to allow recovery of the costs of system upgrades through a streamlined cost-of-service mechanism. See e.g. at ¶ 97. Viacom has advocated such a mechanism,[12] and indeed

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[12] The Commission stated that the streamlined treatment of upgrade costs proposed in the Cost-of-Service Proceeding would be substantially similar to external treatment. Accord Comments of Viacom International Inc. in MM Docket No. 93-215 (filed August 25, 1993) at 42-56; Reply Comments of Viacom International Inc. in MM Docket 93-215 (continued...)

Commission adoption of this proposal is now essential in light of the decision in the Reconsideration Order declining to provide for such costs under benchmark/price cap regulation. Id. at ¶¶ 94-97.

In the Third NPRM, the Commission also has offered constructive, albeit limited, proposals to offer some relief for this problem under its benchmark mechanism, as well. Operators that have recently completed upgrades undertaken prior to regulation should indeed, as the Commission proposes, be allowed to raise rates up to the benchmark without having to undertake a cost showing. Operators typically upgrade their systems pursuant to a business plan that calls for recovery of the capital costs over many years, with steady rate increases rather than a single precipitous jump. If an operator is thus charging rates below the benchmark that do not recover capital improvement costs, an increase to the presumptively reasonable benchmark level should be allowed.[13]

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[12](...continued) (filed September 14, 1993) at 4-7.

[13] To the extent that the cost of upgrades initiated or completed shortly before regulation justify rates beyond benchmark levels, such operators should, of course, remain free to pursue streamlined -- or, if necessary, full -- cost-of-service showings. See Comments of Viacom in MM Docket No. 93-215 at 43 n.7; Reply Comments of Viacom in MM Docket No. 93-215 at 4-7.

Second, consistent with the Commission's external treatment for the costs of meeting franchise obligations, operators must be permitted to pass through to subscribers the costs incurred because of franchise-required upgrades -- both those now under progress and those required in the future. The FCC clarified in its Reconsideration Order that, based on the directives of the 1992 Cable Act, all costs incurred in meeting franchise requirements specifically enumerated in the franchise agreement are eligible for external cost treatment. Reconsideration Order at ¶ 102. Although the cost of a rebuild may be significant, there is no principled basis to treat these costs any differently from other franchise-required costs. Thus, the ability to pass through the costs of required upgrades should not depend upon franchise authority approval.[14]

Furthermore, Viacom submits that rate adjustments based on franchise-required upgrades should be governed solely by the FCC's cost-of-service standards. The 1992 Cable Act directs the Commission, not local regulators, to set the standards for cost-of-service showings. While localities may have a valid interest in reviewing the legitimacy of costs incurred in completing a mandatory upgrade, the standards for

[14] Moreover, because local authorities can weigh the impact of upgrade costs on subscribers at the time they choose to require such an upgrade, local approval of the pass-through of such capital improvement costs is unnecessary. See Reconsideration Order at ¶ 97 n. 160.

such matters as the timeframe for recovering capital improvement costs or the permissible return on those costs are basic cost-of-service issues that -- as the Act mandates -- warrant a uniform federal policy administered by the FCC. The strong national interest in the development of an advanced telecommunications infrastructure requires as much. Local franchising authorities thus should not be placed in the position of establishing cost-of-service regulations inconsistent with those of the FCC. Nor should local authorities be put in the position of making business decisions for cable operators.

III. OPERATORS SHOULD NOT BE REQUIRED TO COST-JUSTIFY BASIC RATES THAT COMPORT WITH BENCHMARK REGULATION OTHER THAN IN COST-OF SERVICE PROCEEDINGS FOCUSED ON THE EXPANDED TIER

While reliance on the cost-of-service approach for the expanded tier and the benchmark/price cap approach for the basic tier could raise possible "gaming" concerns, Viacom offers a proposal that would eliminate that possibility without requiring duplicative cost-of-service showings. Specifically, a system whose costs justify expanded tier rates beyond benchmark levels should be allowed to offer a cost-of-service showing at the FCC without also having to undertake a local cost-of-service showing to justify basic rates that are consistent with benchmark regulation. In the course of this FCC showing, however, operators could be required to demonstrate that their benchmark-abiding basic rates are likewise cost-justified.

Because operators filing cost-of-service showings at the Commission must, perforce, produce cost data reflecting allocations across both the expanded tiers and the basic tier, operators could easily derive the cost-based rate for both tiers and compare it to the benchmark rates. This approach would thus pose no significant increase in the burden on cable operators or the Commission.[15] In contrast, requiring operators with basic rates consistent with benchmarks to make local cost-of-service showings, as well, would significantly increase the burden on local authorities and cable operators alike. Operators would be forced to make duplicative cost showings before two independent -- and potentially inconsistent -- bodies. Moreover, by effectively deterring operators from obtaining fully compensatory rates, the Commission's "uniform regulation" proposal might well undermine the statutory and constitutional backstop provided by the cost-of-service standards.

In any event, in the absence of a strong FCC lead in coordinating federal and local cost-of-service proceedings, local regulators will be forced to confront and decide a variety of complex allocation issues as a matter of first

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[15] See, e.g., Comments of Continental Cablevision in MM Docket No. 93-215 at 78.

impression. This is especially likely given that many franchising authorities will begin the rate review process prior to the FCC's receipt of complaints regarding the rates of enhanced tiers. Inadequate coordination will inevitably result in needless appeals of local decisions to the FCC, as operators struggle with conflicting local decisions.[16]

IV. CONCLUSION

For the foregoing reasons, Viacom respectfully urges the Commission to adopt cable rate regulations that preserve marketplace incentives for the increased investment in programming and system capacity critical to improving the

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[16] Should the Commission nonetheless require a uniform rate regulation methodology, Viacom agrees with the FCC that operators should be permitted reasonable opportunities to switch from benchmarking to cost-of-service and vice versa. See Third NPRM at ¶ 51. A reasonable approach would be to allow operators to make a new election upon the issuance of the Commission's final cost-of-service standards and require that operators otherwise use the same method for no less than one calendar year.

quality and diversity of cable service offerings available to the American viewing public.

Respectfully submitted,

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